Economic Outlook

Irving Trust

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Throughout this business expansion, analysts have been trying to put the recovery into a neat, predictable category. So far, such categorization has proved elusive. Even well after the recovery began, forecasts of a slow recovery were presented, with the unemployment rate moving below 10% only gradually. Instead, the first year and a half after the end of the recession proved to be the very model of a classic, V-shaped recovery, with the unemployment rate dropping below 8% early in 1984. The recovery then seemed so buoyant that concerns shifted to whether the Federal Reserve could bring the economy to a "soft landing" without winding up with a recession. A soft landing was indeed achieved. Now we have all been waiting for the next lift-off, but the flight has been repeatedly delayed. Nevertheless, the odds still favor a pickup in economic activity later this year. If it does materialize, then the current expansion will once again generally look normal in comparison to earlier periods. At the same time, it is unique in important respects. In particular, if the expansion continues for several more years (as we expect), it will prove to be the longest peacetime recovery on record (as far back as the 1850s).

One reason for expecting an improvement in economic activity is the anticipated narrowing of the real merchandise trade deficit as a result of the depreciation of the dollar. The enlargement of the trade deficit was responsible for reducing real GNP growth from the fourth quarter of 1984 to the fourth quarter of 1985 by a full percentage point. Real GNP rose only 2.1% during this period. Other things being equal, a simple shift from minus one percentage point to plus one would make this a 4% growth economy instead of a 2% growth economy. Eventually, the declines in oil prices should also prove generally favorable for the economy. So far, however, most of the visible effects have been negative. For example, the unemployment rate in Texas has risen from 6.4% in January to 9.6% in May.

Several of the economic indicators released in May were surprisingly strong. For example, industrial production rose 0.4% in April (initially reported at +0.2%) following a series of declines, while the index of leading economic indicators rose by a sharp 1.5%. The favorable reports in the economy contributed to a bearish tone in the bond market. Now the latest data have once again highlighted the weakness in the economy. For example, retail sales declined 0.1% in May from the April level, while industrial production fell 0.6%.

The key area of vulnerability in our forecast is capital spending, which has already been falling so far this year. Fortunately, inflation remains relatively low even aside from the effect of oil prices. Some prices have been rising as a result of the depreciation of the dollar, and additional upward pressures from this area can be expected. Most commodity prices remain weak, however, as less developed countries maintain high levels of production to meet their debt obligations. In the late 1970s, when commodity prices were soaring, most nations, including the LDCs, were experiencing strong growth; today, growth among major regions of the world is uneven. These aspects of the economy--financial strains, uneven growth, and overcapacity in many types of commodities--indicate that this expansion has an extraordinary amount of running room.

Bernard Schoenfeld

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Economic Forecast

Percent Changes at Annual Rates

	1985 I	1985 II	1985 III	1985 IV	Actual 1986 I	Forecast 1986 II	Forecast 1986 III	Forecast 1986 IV	Actual 1983-1984	Actual 1984-1985	Forecast 1985-1986
Gross National Product	6.9	4.5	5.8	4.3	5.7	4.1	7.8	8.7	11.0	5.7	5.5
Real GNP	3.7	1.1	3.0	0.7	2.9	2.5	4.1	4.0	6.6	2.2	2.6
GNP Price Deflator	3.0	3.3	2.9	3.3	2.9	1.5	3.4	4.7	4.0	3.3	2.9

	Actual 1986: I	Forecast 1986: II	Actual 1983-1984	Actual 1984-1985	Forecast 1985-1986
Consumer Spending	5.2%	3.2%	8.7%	6.6%	5.2%
Durable Goods	1.2	8.1	14.3	9.2	2.6
Nondurable Goods	-1.8	-2.4	6.8	4.6	3.4
Services	7.6	5.8	8.6	7.3	7.2
Business Capital Spending	-10.4	1.1	20.1	11.3	1.1
Structures	-11.8	0.2	17.0	15.3	-0.6
Equipment	-9.8	1.7	21.7	9.2	2.1
Residential Investment	12.4	22.2	17.8	3.6	14.2
			1984	1985	1986
Change in Inventories	$39.9b.	$13.0b.	$67.1b.	$7.5b.	$23.1b.
Net Exports of Goods and Services	$-105.8b.	$-83.8b.	$-59.2b.	$-78.5b.	$-81.4b.
			1983-1984	1984-1985	1985-1986
Government Purchases	-9.4%	6.8%	9.0%	10.7%	5.1%
Federal	-25.8	7.7	9.9	13.6	3.2
Defense	-5.9	6.7	9.9	10.5	4.8
Other	-60.8	10.7	9.8	23.2	-1.5
State & Local	5.6	6.2	8.4	8.5	6.6
Corporate Profits Before Tax	-1.5*	1.8*	15.9	-5.2	1.9
Corporate Profits After Tax	0.3*	1.2*	10.9	-2.6	1.8
Plant and Equipment Expenditures	-20.1	4.0	16.3	9.0	-1.4
Real Final Sales#	-1.7	5.4	4.5	3.9	2.7
Real Disposable Personal Income	5.5	9.9	5.7	1.6	4.1

Economic Indicators	Recent Data Mar.	Apr.	May	Actual 1983-1984	Actual 1984-1985	Forecast 1985-1986
Consumer Price Index**	-4.8%	-3.6%	n.a.	4.0%	3.8%	2.7%
Producer Price Index for Finished Goods**	-13.2	-7.2	7.2	1.7	1.8	-0.2
Industrial Production	-11.5	5.8	-7.7	11.5	2.2	0.9
Retail Sales##	-0.4	0.4	-0.1	10.5	6.5	3.0
				1984	1985	1986
Auto Sales (millions of units, a.r.)	9.6	11.1	11.3	10.4	11.1	10.8
Housing Starts (millions of units, a.r.)	1.96	2.04	1.89	1.75	1.73	1.89
Unemployment Rate	7.2%	7.1%	7.3%	7.5%	7.2%	7.0%
Merchandise Trade Deficit (a.r.)	$174.3b.	$144.9b.	n.a.	$127.6b.	$144.6b.	$152.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

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#GNP less change in inventories, both in real terms.
##Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).
$b. = billions a.r. = annual rate F = Forecast